NAVY INTERNAL AUDIT --

THE EYES AND EARS OF NAVY MANAGEMENT

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TABLE OF CONTENTS

Chapter		Page
I.	THE BIRTH OF INTERNAL AUDIT	1
	The Void	
	Early Growth	
	Definitions	
II.	LATER GROWTH	4
	Search for Improvements	
	Staff Viewpoint	
	Dual Aspect	
	Acceptance and Rejection	
	A Problem in Human Relations	
	Today	
III.	INTERNAL AUDIT IN THE FEDERAL GOVERNMENT	11
	The Need	
	Evolution	
IV.	NAVY INTERNAL AUDIT	13
	Definition	
	Mission	
	Audit Responsibility	
	Organization	
	Audit Method	
	Functional Areas	
	Financial Auditing	
	Operational Auditing	
	Reduction in Audit Steps	
V.	FUTURE TRENDS	37
	Internal Audit and the Computer	
	Random Sampling	
VI.	SUMMARY AND CONCLUSIONS	40
	Summary	
	Conclusions	
BIBLIOGRAPHY		42

CHAPTER I

THE BIRTH OF INTERNAL AUDIT

The Void

Examine any of the organization charts published prior to 1940 by companies regardless of size. Internal audit appears on few charts. Ask oldtimers: "Who handled the internal auditing before World War II?" Invariably the answer will be that the only audit performed was by a firm of certified public accountants and that personal supervision was conducted by the owner. In preparation for the annual visit of the outside audit agency, the clerical accuracy of the records supporting the balance sheets and income statements was checked by the employees as an addition to their normal duties. Formal historical records of even limited internal audit activity before 1940 are lacking.

Early Growth

As businesses grew in size and complexity after World War II, much of top management fell into the hands of professional managers; a considerable amount of the owner-manager type of control was replaced by share-holder ownership with no one share-holder owning more than one-half of 1% of the voting stock of many large corporations. The owner or the manager soon realized that there were insufficient man-hours in a day, week, or month to cope with the many problems confronting them. The complexity of the far-flung

and diversified operations taxed the knowledge of even the best trained and most experienced men. The result was heavy delegation of responsibilities coupled with much decentralization. With this surrender of personal control by top management to subordinates, the concept of internal audit flourished. The organization of The Institute of Internal Auditors in 1941 marked the beginning of its recognition as a profession. Business prosperity and expansion provided a very favorable environment and it soon achieved formal recognition by its inclusion in corporate organization charts. It achieved informal recognition among management personnel as "the eyes and ears of management."[1]

Definitions

The Institute of Internal Auditors issued in 1947 the "Statement of the Responsibilities of the Internal Auditor" as follows:

> Internal auditing is the independent appraisal activity within an organization for the review of the accounting, financial, and other operations as a basis for protective and constructive service to management. It is a type of control which functions by measuring and evaluating the effectiveness of other types of control. It deals primarily with accounting and financial matters but it may also properly deal with matters of an operating nature.
>
> The over-all objective of internal auditing is to assist management in achieving the most efficient administration of the operations of the organization.[2]

A revised statement was approved by The Institute's Board of Directors on May 30, 1957. It reads:

> Internal auditing is an independent appraisal activity within an organization for the review of accounting, financial and other operations as a basis for service to management. It is managerial control, which functions by measuring and evaluating the effectiveness of other controls.

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[1]E. L. Ratliff, "The Professional Status of Internal Auditing," The Internal Auditor, Vol. XV, No. 4 (December, 1958), p. 9.

[2]Victor Z. Brink, "The Internal Auditor Joins the Management Team," The Internal Auditor, Vol. XIV, No. 2 (June, 1957), pp. 7-8.

> The over-all objective of internal auditing is to assist all members of management in discharging their responsibilities with maximum efficiency, by furnishing them with objective analyses, appraisals and pertinent comments concerning the activities reviewed. Hence the internal auditor should be concerned with any phase of business activity wherein he can be of service to management -- subject only to his own competence to appraise the particular matters under review.[1]

These two statements were analyzed by Victor Z. Brink, one of the founders and a past president of The Institute. In his article, "The Internal Auditor Joins the Management Team," Mr. Brink said:

> It is clear that the substance of these two statements is essentially the same -- the major difference being that of a further extension in the breadth of the internal auditor's role. More specifically the earlier statement emphasized the primary role of the internal auditor in connection with accounting and financial matters and the permissive role with respect to matters of an operating nature. The revised statement on the other hand makes no such distinction and specifically opens the door on an equal basis to all aspects of the operations of the business. The revised statement does, however, add the very proper qualification that the internal auditor must have enough competence in the various operating areas to make his findings and conclusions sound and useful.[2]

This extension in the breadth of the internal auditor's role is the recognition by The Institute of Internal Auditors that the scope of financial review often carries the auditor into the field of operations.

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[1] Ibid., p. 8.

[2] Ibid.

CHAPTER II

LATER GROWTH

Search for Improvements

In line with the changing definition, internal audit has exceeded its early growth. In some companies, it is definitely directed to the challenge of policies, techniques, and procedures -- a realm which is one result following the financial review of the records. "The auditor today must have more than a sense of knowing what is right or wrong in the recording of financial transactions: he must also have a knowledge of the better technique or procedure in accounting for these transactions."[1] It is a steady search for improvements:

> In any balanced auditing program, there should be a constant search for ways to improve and expand the auditing coverage. First, in consideration should come the economic importance of the area under consideration. It will assist the company to the greatest extent if the first activity to be selected is that activity which is the largest part of total production costs or appears to contain the weakest system of internal control commensurate with the importance of the activity involved or presents some special situation for which there is no opportunity for constructive service through problem solution, or covers areas presenting problems akin to those areas already covered.[2]

How is this search to be conducted? The auditor must see beyond the checking of detail and of routine and the observance only of the manner in

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[1]Donald F. Bevis, "Recent Developments in Auditing Techniques," The Federal Accountant, Vol. VI, No. 1 (March, 1957), p. 49.

[2]Donald E. Dooley, "Planning for Operations Auditing," Operations Auditing (New York: The Institute of Internal Auditors, 1958), p. 52.

which each of the accounting divisions functions. William J. Townsend, Senior Auditor for Canada Packers Limited, visualizes the auditor as investigating uneconomical production methods, wasteful expense items, and inferior products as he appraises management and reports on the weaknesses which he finds.[1]

Staff Viewpoint

David J. Dawson, an Administrative Assistant in the Boston Edison Company, stresses the staff viewpoint which the auditor must adopt. His article "The New Look in Internal Auditing," takes to task any auditor who attempts to dictate how to do things. The auditor may be an expert on how to wire an IBM board, operate a generating station or run the customer accounting department, but normally he isn't. Instead he is a specialist in internal control; he writes the reports on internal control. In these reports, he may call attention to management of various facts with which management can make decisions. The auditor reports facts; the operating man makes the decisions.[2]

Dual Aspect

Arthur H. Kent, while General Auditor for Standard Oil of California, cites several examinations which illustrate the dual aspect of internal auditing:

> We circularize customers to verify balances; but we are also alert to indications of customer satisfaction or dissatisfaction with the company's products, delivery service, accounting service or treatment of letters which they may have written.
>
> We examine the age of accounts; but we also follow through to see whether credit policies have been observed, and that collection effort has been aggressive. We note collection losses that have resulted from failure to observe basic company policies.

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[1]William J. Townsend, "Equipping the Internal Auditor for Action," Internal Auditing in Action (New York: The Institute of Internal Auditors, 1951), p. 7.

[2]David J. Dawson, "The New Look in Internal Auditing," The Internal Auditor, Vol. XII, No. 4 (December, 1955), p. 43.

> We verify inventories; but we also analyze the propriety and reasonableness of "losses." We take cognizance of housekeeping conditions, because of their effect on the efficiency of material movements as well as on inventories.
>
> Where we use -- as in my company -- equipment such as barrels to deliver products, we check the accounting records; but we also check on the promptness of operating employees in picking up these barrels when they are empty -- since they represent a large investment and they must be kept in active service. The present steel situation makes this subject of even more vital concern than usual to operating management.
>
> We check invoices in connection with contract drilling or construction work; but we also ascertain whether money has been paid out unnecessarily by reason of failure to enforce contract provisions. This involves, of course, careful reading of contracts. And so with other subjects.
>
> Each company will have its own peculiar operations, but the basic auditing thinking is similar. The auditor, so to speak, wears mental "bifocals". Through one section, he sees the "close-up" -- the sheer accuracy of the figures; through the "distance" portion of the lens, he observes the operations themselves -- the good or bad effect on company success.
>
> So the internal audit becomes an analytical survey of business operations; which in general uses as its base or entree the various company documents and records -- original or summarized.[1]

An auditor has one tremendous advantage over most other company employees. He can see the "big picture." The records are his starting point from which he can cut across organizational lines and delve into all the underlying causes for conditions reflected on the books. He should be able to provide coordination between accounting and all other phases of the business.

The Director, Audit Division, U. S. Steel Corporation, Mr. W. R. Davis, takes the strong position that financial auditing must extend way beyond the accounting records and, in fact, become operational auditing. He explains:

> For about ten years our Internal Audit Division has been performing intensive functional audits involving the pricing and billing of product sales. It has also been making responsibility audits of our sales offices. These audits were

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[1]Arthur H. Kent, "What Has Internal Auditing to Offer Top Management?" Internal Auditing in Action (New York: The Institute of Internal Auditors, 1951), p. 98.

originally requested by the Sales Department, which wanted to be assured that our rather detailed and complicated pricing structure was being accurately reflected in billings to customers. To perform these audits, it was necessary to analyze a sales order from the time it was entered on the company books until it was loaded for shipment to the customer. The auditor therefore had to be familiar with proper order description, efficient production scheduling, actual manufacturing processes, packaging requirements, and shipping practices. This is not as simple as it sounds, for steel products are made to customer specifications and end use. A complete review of the operations involved is necessary if the auditing is to be successful. The review of orders is complicated by the many possible variations in chemistry, physical characteristics, heat treatments, dimensions, and packaging requirements.

In this type of audit, the auditor must be familiar with all phases of the operations. This includes raw-material handling, the operation of such production facilities as coke ovens, blast furnaces, open hearth furnaces, Bessemer converters, electric furnaces, rolling mills for each type of product (such as slabs, sheet, strip, structural beams, bars, and so on), the operation of other machines for producing tin plate, galvanized materials, wire and wire products, tubular products, and many others too numerous to mention. This familiarity must be sufficient to qualify the auditor to discuss constructively his findings with metallurgists, production planning personnel, inspectors, shipping department employees, and any others engaged in processing and shipping a customer's order.

Such an audit is conducted by regular staff members without extensive technical training in operating practices; the necessary ability is acquired through the training and experience gained by the auditor in his regular assignments.

It may be wondered why this is so: the reason is because there is more similarity between so-called "operational audits" and "financial audits" than one may realize. This similarity is due to the fact that, in both types of audits, the auditor is generally reviewing and analyzing records. He can function just as well with records having to do with operating and production matters as he can with strictly accounting records such as those which pertain to payrolls, receivables, payables, and so on. Through experience the auditor becomes able to interpret and utilize records which are maintained in order to permit operating management to appraise its own performance. Of course, the actual physical observation of the operations by the auditor is necessary to supplement his analyses of the records.[1]

In September, 1959, Mr. Kent, now Supervising Auditor of Lockheed Aircraft Corporation, toned down somewhat his previously expressed strong

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[1]W. R. Davis, "Auditing and Its Development in United States Steel," The Federal Accountant, Vol. VI, No. 3 (March, 1957), p. 67.

[illegible] Bass, Shifting and its Development in Musical Sound Trans. The Tonkunst Association, Vol. 23, No. 1 (March, 1923), p. 31.

position relative to extensive operational auditing. He wrote:

> If someone uses the term "operational audits," he is not suggesting that you appraise the operating labors or technical skills of engineers, geologists, machinists, and the like. He is referring to an examination and appraisal of the manner in which a particular organizational activity is administered and conducted. An examination of an operating department requires answers to such questions as:
>
> -- Are the policies under which it operates in conformance with sound business principles?
> -- Are these policies implemented by specific programs and procedures, and are these actually followed?
> -- Is there a clearly understood assignment of individual responsibilities, and are they being performed satisfactorily?
> -- Is documentary information as to operating requirements being conveyed to those concerned in a timely manner, and by orderly methods?
> -- Is the management of the organization provided with accurate and adequate information on matters of primary concern, so that it is thoroughly aware of the condition of affairs in the organization -- and hence is in a position to administer its affairs in the most efficient manner possible?[1]

Acceptance and Rejection

Historically, the auditor has devoted his time to fiscal matters. Internal audit has grown from this accounting background and is an integrated part of it. Any criticism raised by fiscal audit is usually not of the system established but of compliance with the policies and procedures already in being. Failure of compliance is not criticism of management itself but of the employees and hence this type of audit comment is readily acceptable and supported.

The development of "operations audits" as an outgrowth of the review of financial records has had considerable acceptance by many large companies. There has also been much resistance. If operations are found to be faulty,

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[1]Arthur H. Kent, "Internal Auditing is an Appraisal Activity," The Internal Auditor, Vol. XVI, No. 3 (September, 1959), p. 46.

weak, or ineffective, the report that flows out as a result of the examination is a criticism of the management of that department. The report is resented; the internal audit is considered interference with operating management. The internal auditor is encouraged to restrict his appraisal to matters of a fiscal nature.

A Problem in Human Relations

The acceptance of internal audit as an aid to operations is partially a problem in human relations. William T. Jerome, III, in his article entitled, "Internal Auditing as an Aid to Management," recognizes this:

> Having become more aware of the importance of their on-the-job relationships, many auditors no longer conduct their investigations in sleuth-like fashion but instead discuss discrepancies with operating personnel as they arise. This approach has helped reduce some of the groundless suspicions about auditors that might otherwise exist, has led to the development of a more constructive approach in the auditor's relations with plant personnel and in his handling of the examination itself, and has increased opportunities for operating personnel to institute immediate corrective action.[1]

Today

Internal audit is widespread. It is an accepted practice. It is found in the largest of corporations and is used in many smaller ones. It may be a minute function of one man or may comprise three hundred auditors with both central offices and traveling audit groups. It may be limited to the verification of clerical entries or may be a complete program covering verification of records, compliance with policies and procedures, and an appraisal of methods of operation.

It is necessary. The realization of what can be accomplished by constructive auditing has resulted in some form of operational review in every

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[1]William T. Jerome, III, "Internal Auditing as an Aid to Management," Harvard Business Review, Vol. XXXI, No. 2 (March-April, 1953), p. 134.

well organized audit. "The process has been evolutionary rather than revolutionary, and today the base seems quite sound and solid, with the trend clearly evident."[1]

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[1]Ratliff, The Internal Auditor, Vol. XV, No. 4, pp. 14-15.

CHAPTER III

INTERNAL AUDIT IN THE FEDERAL GOVERNMENT

The Need

The Federal Government is big business. It has size and complexity which make it more difficult to properly control than any of the large corporations in industry. Administrators in government like their counterparts in industry cannot personally supervise every facet which requires attention. Responsibility and authority are delegated; some form of review is necessary. Internal audit is one form of review.

Evolution

The war years (1941-45) were not fertile for the development of aids to management. Everyone was too busy increasing production and other aspects of the war effort to worry about waste, inefficiency, or proper controls. After the war, the tremendous costs in running the government became significant again, especially the costs of national defense. The cry for economy stressed the need for improvement in the control of government operations; the costs in the three military departments were favorite targets. Businessmen clamored for a more business-like approach to government administration. When Congress passed the National Security Act amendments of 1949, it recognized the role and usefulness of internal auditing. These amendments "established in each of the three military departments a comptroller

responsible for all budgeting, accounting, progress and statistical reporting, and internal audit in their departments and for related organization structure and managerial procedures."[1] This was the beginning of internal audit in the military departments.

The Budget and Accounting Procedures Act of 1950 further defined the agency responsibility for the audit function. The Assistant Comptroller-General of the United States, Frank H. Weitzel, writes:

> Congress, in enacting the Budget and Accounting Procedures Act of 1950, affirmatively placed upon top agency management the responsibility for the development of internal auditing within each agency. This was a legislative recognition of a basic factor in attaining management control that had already been recognized and applied by progressive business management to the solution of financial and operating problems over the years.
>
> The General Accounting Office looks to agency management to carry out its responsibility for maintaining systems of internal control, including internal audit. We believe that internal audit should be fitted to the needs of each group to be served, and we are stimulating the development of the highest standards in internal audit and encouraging the continued orderly development of existing internal audit functions.[2]

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[1]William A. Newman, Jr., "Evolutionary Changes in Auditing in the Federal Government," The Federal Accountant, Vol. VIII, No. 2 (December, 1958), p. 50.

[2]Frank H. Weitzel, "How the General Accounting Office Looks at Auditing in the Government," The Federal Accountant, Vol. VI, No. 3 (March, 1957), pp. 32-33.

CHAPTER IV

NAVY INTERNAL AUDIT

Definition

The definition of internal auditing in the Naval Establishment is almost identical to the statement published by the Institute of Internal Auditors in 1947. The Navy definition is:

> Internal auditing is an independent appraisal activity within an organization for the review of the accounting, financial, and related operations as a basis for protective and constructive service to management.
>
> Internal auditing is a type of control which functions by measuring and evaluating the effectiveness of other types of control. It is principally an appraisal activity and must be independent to be effective.[1]

Mission

Included in the "Preliminary Statement, Department of Defense Audit Policies with Respect to Organization and Mission" is the general mission of internal audit:

> Internal auditing is a staff function which, to operate effectively, must be completely independent of line operations. The internal auditor's responsibility is to observe, review, appraise, evaluate, and examine financial and accounting policies, systems, and procedures, and performance thereunder, respecting all resources and operations (including reporting) for the purpose of reporting findings and recommendations for corrective action to management. The existence of an internal audit staff in no way relieves other personnel of duties and responsibilities assigned to them. Full responsibility is vested in the operating groups for proper protection and use of the assets of the organization;

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[1]U. S. Department of the Navy, Office of the Comptroller, "Internal Audit of the Naval Establishment," NAVEXOS P-1501, 1956, p. 3.

for compliance with policies, procedures, and objectives; and for the accuracy, propriety, legality, and reliability of their actions.

The internal auditor does not have the authority to make changes, or order changes made, in the procedures or operations of the activities audited. The internal auditor is not responsible for developing systems, methods and procedures, nor for the performance of duties constituting a part of regular line operations. Such responsibilities would tend to give him a biased viewpoint when, in the course of his audits, he would be required to appraise his own work. The auditor, based upon his independent examinations, reviews, and appraisals, provides an advisory service and makes recommendations to management for improvements in existing organizations and systems, and for the correction of deficiencies. It is the responsibility of management to determine what action will be taken and to give the required corrective orders. This, however, does not relieve the internal auditor of the responsibility for following up on his recommendations to determine whether they were given adequate consideration and that management's orders to accomplish changes and correct deficiencies were effectuated.[1]

Audit Responsibility

The Comptroller of the Navy has internal audit responsibility for all naval activities, ashore and afloat. The responsibility for the audit of Nonappropriated Fund Activities (Commissioned Officers' Messes, Enlisted Men's Clubs, Recreation Funds, etc.) is limited to a review and evaluation of the command audit. Credit Unions and Navy Relief Society Auxiliaries are not part of the Naval Establishment.[2]

Organization

The "Preliminary Statement, Department of Defense Audit Policies with Respect to Organization and Mission" spelled out the organization at the Military Department Level:

1. All operating audit responsibilities . . . both continental U. S. and overseas, will be carried out by a single central audit organization in each department in order to assure independence and to avoid duplication. The head of each audit organization shall be responsible to the Assistant Secretary for Financial Management.

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[1]U. S. Office of the Assistant Secretary of Defense, Comptroller, Preliminary Statement, Department of Defense Audit Policies with Respect to Organization and Mission, January 31, 1955.

[2]U. S. Department of the Navy, Office of the Comptroller, "Navy Internal Auditors Handbook," NAVEXOS P-2055, p. 1-4.

2. Such field offices may be established as will most effectively and economically carry out the mission of the audit organization. . . .

3. No separate audit organizations will be established at any other level. . . .[1]

There are nine hundred and seventy-three professional accountants in the Navy audit organization. Three hundred and thirty of these are internal auditors. Thirty-three bureaus, offices, and major field activities are under continuous internal audit to provide management with more timely and effective audit service. Ultimately the activities under continuous audit will total forty-five. Other major activities are audited once every two years. Minor activities are audited once every three years. Disbursing audits are given annually.[2]

Audit Method

Audits are conducted by the utilization of standard internal audit programs. These programs review procedures and internal controls to determine if they are in effect and if they are working, i.e., to determine their reliability, fidelity, etc. This is accomplished by examination of the books, records, and reports. In an address to the members of the Navy Graduate Comptrollership Program, Captain J. B. Kackley, SC, USN, Assistant Comptroller, Department of the Navy, stated, "Transactions are test checked, not to locate errors, but to ascertain whether there are errors, whether there are weaknesses in the systems, and what can we do to cover these weaknesses."[3]

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[1]U. S. Office of the Assistant Secretary of Defense, Comptroller, Preliminary Statement, Department of Defense Audit Policies with Respect to Organization and Mission, January 31, 1955.

[2]Captain J. B. Kackley, Assistant Comptroller, Department of the Navy, An Address to Members of the 1959-1960 Navy Graduate Comptrollership Program, The George Washington University, Washington, D. C., March 18, 1960.

[3]Ibid.

Internal audit programs are prepared prior to the commencement of the audit of an activity function. They are similar to the check-off lists used for many years in the Navy by various inspectors. Several arguments have been advanced against the use of the program approach. First, it has been claimed that formal written programs stifle initiative. The second objection is that the audit steps become well-known and prepared for.

The program may stifle initiative but only if the auditor has no initiative. He is not bound by the audit steps. They are written out in advance to make certain that he doesn't miss any important points. It is to management's advantage that the audit steps become well-known; one hundred per cent pre-preparation resulting in no error indication is a goal seldom realized. When the audits are carried out in many locations and by many persons, written programs ensure uniformity of approach and emphasis.

Functional Areas

These programs are based generally on functional areas. "A functional area comprises all phases of the operations at a naval activity which are directly related to the same basic function and can be audited as an entity through the various organizational units in which they appear."[1] In 1956, the functional areas covered by Navy internal audit were:

1. Budgeting;
2. Procurement;
3. Appropriation and Fund Accounting;
4. Plant Property Accounting;
5. Stores Accounting;

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[1]U. S. Department of the Navy, Office of the Comptroller, "Navy Internal Auditors Handbook," NAVEXOS P-2055, 1959, pp. 1-3.

6. Cost Accounting and Statistical Reporting;

7. Timekeeping and Civilian Payrolls;

8. Disbursing;

9. Navy Industrial Fund Accounting; and

10. Non-appropriated Fund Accounting.[1]

Four additional functional areas have been added:

11. Navy Rental Housing Facilities;

12. Supply Management;

13. Inventory Management; and

14. Government Property in the Possession of Contractors.[2]

A program has been written to cover each of these areas except Navy Industrial Fund Accounting and Nonappropriated Fund Accounting. The audit of Navy Industrial Fund Accounting will deal with those matters concerned with the accounts and accounting procedures prescribed by the Navy Industrial Fund Handbook pertaining to the activity under audit.[3] The Comptroller of the Navy has only limited audit responsibility for Nonappropriated Fund Activities.[4]

Financial Auditing

An examination of the programs covering the first eight functional areas discloses that the audit steps are built around the verification of computations and the compliance with directives. The steps follow closely the pattern of "financial auditing" covered by the original Institute of Internal

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[1]U. S. Department of the Navy, Office of the Comptroller, "Internal Audit of the Naval Establishment," NAVEXOS P-1501, 1956, pp. 16-19.

[2]NAVEXOS P-2055, pp. 1-3.

[3]Ibid., pp. 5-11.

[4]Ibid., pp. 1-4.

Auditors' "Statement of the Responsibilities of the Internal Auditor."

Examples are:

> In the presence of the disbursing officer, count all the cash in his safes.[1]
>
> Determine whether the responsibility of the disbursing officer, insofar as the handling, custody and accountability of funds is concerned, is limited to funds placed in his custody by operation of a law or regulation, or pursuant to orders of the Secretary of the Navy.[2]
>
> Determine whether each appointed deputy, agent cashier, or other agent officer has been properly authorized to have custody of public funds.[3]
>
> Determine whether the disbursing officer and each appointed deputy agent, cashier, or other agent officer has exclusive possession of the combination to his safe.[4]
>
> Determine whether the procedures used by the disbursing officer to ascertain that any cash received is in the correct amount are adequate.[5]
>
> Review the cash book to determine whether amounts collected by deputies, agent cashiers, and other agents are reported to and properly recorded by the disbursing officer daily. When deputies, agent cashiers, and other agents retain cash collections, determine whether the disbursing officer obtains adequate receipts for the retained amounts.[6]
>
> Determine whether the pay records of all military personnel who have access to the pay records are properly marked "PRA" /Pay Record Access/. Verify the entries on all pay records which are marked "PRA."[7]

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[1]U. S. Department of the Navy, Office of the Comptroller, Internal Audit Division, Internal Audit Program No. 1, Revision No. 2: Disbursing, December, 1959, Audit Step A-1, p. 6.

[2]Ibid., Audit Step C-1, p. 9.

[3]Ibid., Audit Step C-2, p. 9.

[4]Ibid., Audit Step C-3, p. 9.

[5]Ibid., Audit Step D-1, p. 12.

[6]Ibid., Audit Step D-2, p. 12.

[7]Ibid., Audit Step E-14, p. 16.

Determine whether incorrect entries on pay records are properly lined through and initialed.[1]

Test check the correctness of the effective dates of increases or decreases in pay and allowances which are the result of changes in rank or rating, by tracing such entries to appropriate substantiating documents.[2]

Test check pay records by computing total pay due less payments made for verification of balance due. Include PRA records with such tests.[3]

Verify the mathematical computations of closed entries and determine whether the rates and periods covered were properly recorded on the pay records.[4]

Determine whether the timekeeper or other authorized person reconciles the total hours as shown on the time card with the labor distribution shown thereon, or with separate labor cards, when used.[5]

Determine whether the fiscal timekeeping staff periodically test checks the accuracy of the labor distribution as marked on the labor cards. Where errors have been discovered, evaluate the corrective action taken by the fiscal officer.[6]

Determine whether the official leave records are maintained on NavCompt Forms 206 or 206 (1C), "Service Cards".[7]

Determine whether leave is posted to the Service Cards at least weekly.[8]

Verify the accuracy of salary rates of recently promoted employees. Determine whether promotions are improperly given retroactive effect.[9]

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[1]Ibid., Audit Step G-3-3, p. 22.

[2]Ibid., Audit Step G-3-4, p. 22.

[3]Ibid., Audit Step G-3-8, p. 23.

[4]Ibid., Audit Step G-3-11, p. 23.

[5]U. S. Department of the Navy, Office of the Comptroller, Internal Audit Division, Internal Audit Program No. 2: Timekeeping and Civilian Payrolls May, 1957, Audit Step A-12, p. 4.

[6]Ibid., Audit Step A-13, p. 4.

[7]Ibid., Audit Step A-18, p. 5.

[8]Ibid., Audit Step A-21, p. 5.

[9]Ibid., Audit Step B-10, p. 10.

Determine whether the summary records of employees' insurance withholdings and the employer's contribution are in agreement with the general ledger control account.[1]

Determine whether overtime is credited and the overtime pay is computed in accordance with instructions contained in NCPI.[2]

Trace the beginning and ending balances of the Payroll Control Register for each pay period selected to the preceding and succeeding Payroll Control Registers.[3]

Determine whether the earnings of employees are frequently summarized and balanced with the year-to-date payroll controls.[4]

Determine whether physical inventories and reconciliations are completed in accordance with prescribed schedules.[5]

Determine the adequacy of the records maintained to ensure strict control of Navy identification numbers for plant property.[6]

Examine the last Reconciliation of Plant Account (NavCompt Form 167) report prior to the audit and reports of several other recent months for the audited activity and a number of activities selected from the schedule prepared in Step 3 of Section A. Unless otherwise noted, audit <u>each</u> report selected. . . .[7]

Determine whether plant property installed or otherwise made available for use is reported promptly to the fiscal officer.[8]

Examine several transactions involving plant property acquired on an adjustment acquisition basis and determine whether prescribed procedures are being observed in the processing of such transactions.[9]

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[1]<u>Ibid.</u>, Audit Step B-20, p. 11.

[2]<u>Ibid.</u>, Audit Step B-25, p. 11.

[3]<u>Ibid.</u>, Audit Step B-41, p. 15.

[4]<u>Ibid.</u>, Audit Step B-49, p. 16.

[5]U. S. Department of the Navy, Office of the Comptroller, Internal Audit Division, <u>Internal Audit Program No. 6: Plant Property Accounting</u>, September, 1957, Audit Step A-4, p. 5.

[6]<u>Ibid.</u>, Audit Step A-8, p. 6.

[7]<u>Ibid.</u>, Audit Step B-2, p. 8.

[8]<u>Ibid.</u>, Audit Step C-5, p. 13.

[9]<u>Ibid.</u>, Audit Step C-6, p. 13.

Determine whether plant property, wherever possible, is recorded in plant account at cost, including installation charges as shown by job orders, stub requisitions, time cards, or other documents reflecting cost.[1]

Examine a representative number of survey actions and documents in support thereof. Determine whether they have been accomplished in accordance with current directives and determine whether they are justified and not processed merely for the purpose of effecting arbitrary reduction of plant property values. Verify that disposition of the property has been accomplished as directed in the survey.[2]

Examine a number of transactions involving intra-activity transfer of plant property and where installation costs are a factor, determine whether such costs are charged to plant maintenance and repairs (44000 series of expenditure accounts).[3]

Determine whether the stores returns and related appropriation reports are certified by the responsible officer. If the returns are certified by a subordinate, determine whether a written delegation of authority to sign is on file.[4]

Reconcile the amounts reported on the NavCompt Form 176 with supporting Memorandum Invoices into Store (SandA Form 158).[5]

Determine that the SandA Form 222 and NavCompt Form 870 are properly prepared and supported and that only authorized appropriations are reported.[6]

Summaries received. Prove the amount reported as the total value of summaries received with supporting Summaries of Invoices Covering Transfers of Stores Between Supply Officers (NavCompt Form 177). Test check the amounts shown on the Summaries with supporting invoices and note particularly whether the invoices and the Summary cite the same stores account and accountable activity.

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[1] Ibid., Audit Step C-9, p. 14.

[2] Ibid., Audit Step D-1, p. 15.

[3] Ibid., Audit Step E-3, p. 16.

[4] U. S. Department of the Navy, Office of the Comptroller, Internal Audit Division, Internal Audit Program No. 8: Stores Accounting, January, 1958, Audit Step A-6, p. 5.

[5] Ibid., Audit Step B-2-b, p. 8.

[6] Ibid., Audit Step B-3-d, p. 9.

Captions (a) and (c).

(1) Verify that amounts reported in Captions (a) and (c) of the last statement prior to the audit are substantiated by unmatched documents in the files.

(2) Determine whether the unmatched documents are aged and reported properly.[1]

Determine whether issues to foreign governments without reimbursement are reported opposite this caption.[2]

Compare the summary invoices processes to adjust unmatched public vouchers and unmatched summary invoices with contra-adjustments included in the balance sheet captions "Purchases" and "Transfers from other Supply Officers."[3]

Reconcile several invoice groups listed in the Summary with supporting invoices and note particularly whether the invoices cite the same stores account and accounting number of the activity that is to report receipt of material as cited in the summary.[4]

Review each project order for compliance with the principles governing the use of project orders as indicated in the cited references. Describe and include in the working papers a copy of each project order found to be in violation of regulations.[5]

Review the procedures for classifying transactions as funded reimbursable transactions, and direct charge work and determine compliance with the cited references. Be particularly alert to detect failure to establish receivables for unfunded transactions required to be recorded at the field level.[6]

Determine whether the disbursing officer notifies the commanding officer of the amount advanced to the Naval Working Fund to cover the cost of work or services to be performed and whether the deposit is approved for incurring obligations by the commanding officer.[7]

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[1] Ibid., Audit Steps B-15-a and b, p. 13.

[2] Ibid., Audit Step C-11-b, p. 17.

[3] Ibid., Audit Step B-19-b, p. 19.

[4] Ibid., Audit Step B-22-b, p. 19.

[5] U. S. Department of the Navy, Office of the Comptroller, Internal Audit Division, Internal Audit Program No. 9, Revision No. 1: Appropriation and Fund Accounting, August, 1959, Audit Step A-12, p. 7.

[6] Ibid., Audit Step A-15, p. 7.

[7] Ibid., Audit Step A-21, p. 9.

Determine whether the balances of general ledger Accounts 200, Funded Accounts Receivable, and 700, Funded Reimbursable Transactions, are in agreement.[1]

Examine a number of journal vouchers and verify that proper accounts are debited and credited and that the amounts are correct and in agreement with supporting documents. Investigate any unusual adjusting journal vouchers.[2]

Determine whether collections for funded and unfunded accounts receivable transactions are properly reconciled with reimbursement registers received from Navy regional accounts offices and Headquarters Marine Corps.[3]

Determine whether all commitments and obligations incurred prior to the close of the reporting period are included in the Allotment Reports (NavCompt Form 2025).[4]

Of the four functional areas added after 1956, Navy Rental Housing Facilities follows the pattern of "financial auditing". Examples are:

Immediately upon arrival at the housing office, count in the presence of the collection agent all cash and cash items on hand.[5]

Review the procedures used to determine occupancy eligibility and ascertain that they are in accordance with stated Navy policy.[6]

Test check dwelling unit condition inspection and furniture inventory records to determine whether they are being properly maintained.[7]

Determine whether cash receipts are deposited intact with the disbursing officer or a designated Government depository at least twice weekly.[8]

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[1] Ibid., Audit Step B-3, p. 11.

[2] Ibid., Audit Step B-9, p. 12.

[3] Ibid., Audit Step B-15, p. 13.

[4] Ibid., Audit Step C-5, p. 14.

[5] U. S. Department of the Navy, Office of the Comptroller, Internal Audit Division, Internal Audit Program No. 3: Navy Rental Housing, July, 1957, Audit Step A-1, p. 4.

[6] Ibid., Audit Step B-5, p. 6.

[7] Ibid., Audit Step B-7, p. 6.

[8] Ibid., Audit Step C-1, p. 7.

Determine whether all persons handling cash are properly designated as collection agents by the Commanding Officer and have been confirmed by the Comptroller of the Navy or the Commandant of the Marine Corps, as appropriate.[1]

Determine whether all rents and tenants' deposits are collected either in advance or within the first ten working days of the month in which due.[2]

Determine whether delinquent accounts are written-off only after receipt of written approval of the Commanding Officer.[3]

Examine the Statement of Collections (NavCompt Form 2012) for the month preceding the month in which the audit commenced and for several other representative months during the period covered in the audit. Before performing the following audit steps, prove the arithmetical accuracy of the statement. . . .[4]

Operational Auditing

Despite this emphasis on verification of computations and the compliance with directives, each of the programs contains some audit steps which could be classified as "operational auditing." Examples are:

Review and evaluate procedures for paying civilian and military travel and allowance claims. Test check such procedures by tracing data from vouchers to orders and other supporting documents and by determining whether only proper and reasonable claims are paid. Determine whether proper accounting data are shown on disbursing documents.[5]

Determine whether the payroll function is kept separate from:
a. timekeeping
b. labor cost distribution
c. pay check or cash distribution
Review the organization chart to determine whether this segregation of responsibilities has been provided for and verify that the provision is being adhered to. Where it is found that

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[1] Ibid., Audit Step C-3, p. 7.

[2] Ibid., Audit Step C-4, p. 7.

[3] Ibid., Audit Step C-9, p. 8.

[4] Ibid., Audit Step C-11, p. 8.

[5] Internal Audit Program No. 1, Revision No. 2: Disbursing, Audit Step E-25, p. 18.

these duties have not been segregated, examine the procedures being followed and comment on them in the working papers.[1]

Determine whether the personnel responsible for the preparation of payrolls are frequently rotated so as to prevent an individual from preparing the same payroll week-after-week.[2]

An important element of internal control is exercised through periodic comparisons of civilian position descriptions with duties actually performed. Observe whether a personnel survey program is in operation and obtain information concerning the results of recent surveys.[3]

Observe whether the housing office is suitable with regard to working space, lighting, ventilation, arrangement, etc., to have a favorable effect on employee performance.[4]

Observe and comment in the working papers on the general cleanliness of the housing compound or area, the state of upkeep of grounds, the state of repair of housing units and such other matters pertaining to the physical condition of the facilities as may be noteworthy.[5]

Evaluate the extent that personnel responsible for the administration of the housing project engage in the development of the budget therefor.[6]

Review the plans, assumptions, historical data, and computations upon which the budget is based.[7]

Determine from Step 3 above whether due consideration has been given to such factors in the development of the budget as:

a. past plans and accomplishments
b. past estimates compared with actual obligation experience
c. realistic attainment of present projected plans

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[1]Internal Audit Program No. 2: Timekeeping and Civilian Payrolls, Audit Step B-1, p. 8.

[2]Ibid., Audit Step B-2, p. 8.

[3]Ibid., Audit Step B-59, p. 18.

[4]Internal Audit Program No. 3: Navy Rental Housing, Audit Step B-2, p. 7.

[5]Ibid., Audit Step B-10, p. 8.

[6]Ibid., Audit Step D-1, p. 12.

[7]Ibid., Audit Step D-3, p. 12.

d. anticipated variations in operations, costs, and personnel
e. work measurement statistics.[1]

Review activity inventory procedures, and evaluate the adequacy thereof particularly with regard to the following matters:

a. the responsibilities of each representative of management assigned to the task of taking a physical inventory of plant property;
b. assurance of complete coverage by the assignment of specific inventory areas with target dates for completion;
c. indoctrination of inventory personnel;
d. specific operating techniques to be followed in sighting, tagging, describing, recording, and reporting plant property items;
e. inspection of inventory areas after inventories have been reported completed;
f. instruction for the preparation of an inventory progress report for local management;
g. physical inventory of items of plant property which are inaccessible.[2]

Comment on the effectiveness of records management, particularly with regard to:

a. adequacy, availability and arrangement of records and copies of returns, reports and vouchers or listings in lieu thereof; and
b. disposal of records.[3]

Review and evaluate procedures for establishing obligations for miscellaneous service (i.e., rentals, utilities, credit card purchases, communications, etc.) for which billings are not received from the contractor in time to be entered as an obligation in the month in which the services were received. Determine the accuracy and validity of any estimates established for such services and ascertain whether amounts are computed, to the extent possible, from meter readings, procurement tickets, or other records of services received.

Review and evaluate procedures for recording obligations for civilian labor and employer contributions.[4]

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[1] Ibid., Audit Step D-4, p. 12.

[2] Internal Audit Program No. 6: Plant Property Accounting, Audit Step A-5, p. 6.

[3] Internal Audit Program No. 8: Stores Accounting, Audit Step A-4, p. 5.

[4] Internal Audit Program No. 9, Revision No. 1: Appropriation and Fund Accounting, Audit Step D-2-b and c, p. 17.

Every audit program has one audit step covering the effectiveness of the activity's staff. The step itself varies according to the jobs being performed. The following example is typical of the others:

> Evaluate and comment in the audit working papers on the effectiveness of the activity's staff responsible for accounting for fund resources, taking into consideration the following matters:
>
> a. staffing requirements for current work load;
> b. accuracy and reliability of work product;
> c. timeliness of reporting to fund administrators and management bureaus or offices;
> d. awareness and understanding of directives currently in force;
> e. extent of supervision, guidance, and training;
> f. extent of cooperation and assistance extended to "customers" (fund administrators).[1]

Programs in the functional areas of Budgeting, Procurement, and Cost Accounting clearly show the trend to devote less attention to the verification and compliance features of internal audit. Many of the audit steps in these programs encourage the constructive examination of job performance and the critical analysis of the procedures set up by management. Examples are:

> Review the instructions provided by the bureaus, offices, and commands for the preparation and justification of budgetary requests.
>
> a. Evaluate the instructions in terms of adequacy, timeliness and consistency.
> b. Include in the working papers those instructions which are considered unsatisfactory and comment on ambiguities or other deficiencies.[2]

> Determine whether the activity has a budget board or other appropriate committee.
>
> a. Ascertain whether it has sufficient authority to initiate and direct the development and review of budget estimates.
> b. Determine whether the board holds hearings where estimates can be justified by those who prepare them. Where hearings are not held, describe and evaluate the methods of review.
> c. Comment on the adequacy and effectiveness of the action taken as a result of the hearings or other methods of review.[3]

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[1] Ibid., Audit Step A-25, pp. 9-10.

[2] U. S. Department of the Navy, Office of the Comptroller, Internal Audit Division, Internal Audit Program No. 7: Budgeting for Appropriated Funds, November, 1957, Audit Step B-1, p. 3.

[3] Ibid., Audit Step B-5, p. 4.

Review the working papers which support the budget estimates.

a. Determine whether the working papers are in sufficient detail to enable determination of the validity of the estimates.
b. Determine whether the working papers indicate that the estimates were based upon:
   (1) Accounting data relating to past performance;
   (2) Planned workload;
   (3) Work measurement programs or other statistical analyses;
   (4) Unit costs applied to quantitative objectives;
   (5) Anticipated variations in operations or cost; and
   (6) Organizational changes involving an increase or decrease of the personnel complement.
c. Ascertain that significant variations from prior year's estimates or new accounts not previously budgeted for are explained in detail.[1]

Review the action taken by the activity (Commanding Officer, Comptroller, Budget Officer, Planning Committee, etc.) to develop firm activity plans for the accomplishment of the work program.[2]

Evaluate the procedures followed by the activity to provide funds for unforeseen events.[3]

Review and evaluate the procedures for reviewing program performance against the funding plan, analyzing deviations therefrom, and recommending remedial action where appropriate. Evaluate the action taken by department heads to implement the recommendations reported to them.[4]

Evaluate and comment in the working papers on the adequateness and appropriateness of the division of duties among personnel responsible for requesting procurement, placing orders, receiving materials and services, and paying for such materials and services. Where appropriate, this evaluation will be performed in conjunction with the audit of the Supply Management, Disbursing and other pertinent functional areas. Such evaluation will include consideration of internal checks to insure placing of authorized orders for required materials and services, payment for authorized actual receipts, and prevention of fraudulent practices. The evaluation will be made in connection with all types of procurement actions

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[1] Ibid., Audit Step B-8, p. 5.

[2] Ibid., Audit Step B-3, p. 3.

[3] Ibid., Audit Step C-4, p. 7.

[4] Ibid., Audit Step C-6, p. 8.

(e.g. various types of small purchases, formal advertising and negotion).[1]

Evaluate the appropriateness of the procurement responsibility and authority held by the activity. Consider possible savings or improved effectiveness if the following action were taken.

a. Consolidation of part, or all, of the designated procurement responsibility and authority with centralized buying activities.
b. Decentralization to activities with limited procurement responsibility and authority.
c. Extension or reduction of the scope of procurement responsibility and authority.[2]

Ascertain the elapsed time from date of purchase requisition to date of contract execution on a representative number of purchase actions utilizing various purchase methods. Evaluate the reasonableness of such elapsed time and if it appears to be excessive determine the cause thereof.[3]

Ascertain whether the activity has an established procedure for avoiding single-source procurement whenever appropriate. Review a representative number of purchase requests which indicate that only one source should be solicited and evaluate the contracting officer's action upon such requests. Evaluate procedures concerning the activity's review of specifications on purchase requisitions which are written in such a manner as to obstruct or prevent appropriate competition.[4]

Determine whether an attempt is made to ascertain the reason when contractors do not answer a request for proposal. Analyze and evaluate the reasons given by contractors for not submitting quotations.[5]

Review and evaluate procedures for issuance, amendment, cancellation, and completion of job orders.

a. Determine whether job orders are properly authorized prior to issuance.
b. Ascertain whether the fiscal office, or other office responsible for maintaining official job order files, is notified promptly upon issuance, amendment, cancellation, and completion of job orders.

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[1]U. S. Department of the Navy, Office of the Comptroller, Internal Audit Division, Internal Audit Program No. 10: Procurement, June, 1958, Audit Step A-15, pp. 8-9.

[2]Ibid., Audit Step A-20, pp. 9-10.

[3]Ibid., Audit Step A-30, p. 12.

[4]Ibid., Audit Step B-1-i, p. 13.

[5]Ibid., Audit Step F-17, p. 28.

c. Determine whether all open job orders are reviewed periodically and referred to originating offices for determination as to whether they should be closed. Review the action taken in response to such inquiries.[1]

Obtain information from personnel responsible for the reports analysis and control program or from other appropriate sources concerning the extent and nature of reports prepared by the activity. Select a representative number of cost and other type reports, excluding those subject to audit in other functional areas, and briefly describe such reports in the audit working papers. . . . Review and Evaluate procedures for assembling the required data, the preparation of such reports, and the utilization thereof.[2]

The programs which make the most extensive use of operational auditing techniques are in the functional areas of Inventory Management and Supply Management. The following are representative examples of these audit steps:

List at least 100 representative items which are not in long supply, and trace each item through the most recent stratification process. . . . Analyze the supply-demand review for each item as to:

a. basis of estimating demand (e.g. use of sales forecasts).
b. basis for establishment of peacetime operating stocks and mobilization reserves. (Note: auditors should be particularly alert to inflation of the M-Day Material Requirement as a device for avoiding the acknowledgement of a long supply condition).
c. timeliness of action to adjust supply (by procurements, transfers within the system, etc.) to demand.[3]

List at least 100 representative items which are in long supply and make determinations as in the previous step.[4]

Analyze the basis for determination of the frequency of replenishment shipments to distribution points, and determine whether such frequency determination has been established on the basis of all pertinent factors, such as:

a. geographical and climatic conditions.
b. seasonal characteristics as to procurement or delivery.
c. characteristics of the item or category of items.
d. size of shipments and carrier capability.

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[1]U. S. Department of the Navy, Office of the Comptroller, Internal Audit Division, Internal Audit Program No. 14: Cost Accounting, May, 1959, Audit Step A-6, p. 6.

[2]Ibid., Audit Step A-15, p. 10.

[3]U. S. Department of the Navy, Office of the Comptroller, Internal Audit Division, Internal Audit Program No. 4: Inventory Management, July, 1957, Audit Step IV-8, p. 17.

[4]Ibid., Audit Step IV-9, p. 17.

e. economy of procurement or delivery quantities.
f. storage and holding costs.
g. inventory investment.[1]

Analyze the procedures employed by the SDCP /Supply Demand Control Point/ or bureau to review the safety level of supply for each activity submitting periodic stock status reports. Auditors should be particularly alert that the safety level of supply is not used as a device to inflate the authorized level of supply and thereby reduce or entirely eliminate the declaration of items as being in long supply.[2]

Select several (at least 25) representative, fast moving items of inventory and for each item trace the movement of stocks both into and within the system. . . . Determine whether such analysis indicates that unnecessary cross hauling has been eliminated. . . .[3]

Examine several items of stock which show little or no activity. Explore the possibility and reach a conclusion as to the practicability of reducing the aggregate inventory of the items by reducing by attrition the number of stock points at which the item is held. . . .[4]

Determine whether the inventory manager's procedures provide for the analysis of each of the items in long supply and whether the decision to retain the long supply position of such items is predicated on a comprehensive analysis, consisting of at least the following elements:

a. the period required to consume the long supply portion of the items, based upon valid forecasts of operating requirements.
b. the costs of retention (i.e. storage, handling, preservation, etc.), for the long supply portion of the total stocks over the period of their consumption, as compared with
   (1) the estimated price of procurement to maintain a satisfactory stock position over the period, and
   (2) the estimated net return to the Government from current sale of the long supply portion of the item as Surplus Property.[5]

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[1] Ibid., Audit Step IV-10, pp. 17-18.

[2] Ibid., Audit Step IV-11, p. 18.

[3] Ibid., Audit Step IV-23, p. 20.

[4] Ibid., Audit Step IV-24, p. 20.

[5] Ibid., Audit Step VI-1, p. 24.

Examine the history of each item in the sample being used in this part with a view to determining why a condition of long supply arose. Be particularly alert for recent procurements and carefully examine the written documentation pertaining thereto. Include in the working papers conclusions as to reasons for the condition of long supply for each item examined.[1]

In conjunction with the audit of other functional areas, determine whether the planning organizational unit or similar organizational components of the Supply Department perform unnecessary budgeting, cost accounting, allotment accounting, plant property accounting, and reports and forms control functions or maintain unnecessary personnel and attendance records, etc., which duplicate responsibilities of other organizational components of the audited activity. If unnecessary work is being performed, determine the cause(s) therefor.[2]

Determine whether the lines of communication between the Receipt Control Branch and the Receiving Section are sufficiently adequate so as not to interrupt the movement of material or related documents.[3]

Review the rail car records pertaining to inbound and outbound car movements. Evaluate the records in terms of the control they provide over car loading and unloading and release. Determine whether unnecessary demurrage charges are being paid carriers. Ascertain whether receipt for car load lots is accomplished at the storage area whenever possible to eliminate unnecessary handling.[4]

Review the procedures for receiving material which is inspected at destination.

a. Review and evaluate the extent to which technically qualified personnel are required to inspect materials.
b. Determine whether material is inspected to ascertain that preservation, packaging, packing, and marking conforms to the specification in the purchase document. Observe material inspection operations and determine whether the destruction of preservation and packaging material is kept to a minimum.[5]

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[1] Ibid., Audit Step VI-6, p. 25.

[2] U. S. Department of the Navy, Office of the Comptroller, Internal Audit Division, Internal Audit Program No. 12: Supply Management, October, 1958, Audit Step A-16, p. 8.

[3] Ibid., Audit Step D-3, p. 20.

[4] Ibid., Audit Step D-6, p. 21.

[5] Ibid., Audit Step D-13, p. 23.

Review the circumstances in which a survey is required and determine whether surveys are being made wherever necessary.[1]

Through a visual inspection of packaged material in selected storage areas, evaluate the adequacy of the preservation program, i.e., whether the shelf life stamped on the containers has expired, whether gasoline and diesel engine spares, various types of hand tools, and bearings are properly preserved, etc.[2]

Determine whether materials are being overpreserved, e.g., 25¢ may be expended to prevent rust on a stainless steel nut valued at only 10¢.[3]

Determine whether insurance type items are reviewed periodically for the purpose of reducing the stocks of such material to a minimum. Review and evaluate the action taken as a result of the last review performed. Determine whether insurance type items are properly classified as such.[4]

Reduction in Audit Steps

NAVCOMPT NOTICE 7520 of 29 February 1960 reduces the number of audit steps in internal audit programs covering Inventory Management, Procurement, and Supply Management. The stated purpose is "to reduce the diversion of audit effort to those areas less likely to be of significance from an internal audit standpoint."[5] The following are deleted steps:

Review and evaluate the effectiveness and adequateness of supply management services furnished to consumer units of the audited activity and nearby dependent activities. Determine by discussion with operating personnel, such as those employed in production and public works shops, whether requested materials are furnished in adequate quantities; of accepted quality, and in a timely manner. Determine whether operating personnel are adequately informed concerning the materials that are available from local stock.

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[1] Ibid., Audit Step E-15-c, p. 28.

[2] Ibid., Audit Step F-9-d, p. 34.

[3] Ibid., Audit Step F-9-e, p. 34.

[4] Ibid., Audit Step J-16, p. 52.

[5] U. S. Department of the Navy, Office of the Comptroller, NAVCOMPT NOTICE 7520, 29 February 1960.

Investigate instances of alleged inadequate supply service and determine the cause(s) therefor.[1]

Review the storage plan and various reports concerning storage space and utilization thereof. Determine where various types of storage facilities are located and where various types of materials are stored. Visit selected storage areas (both open and covered, fuel farms, etc.) and evaluate the effectiveness and economy of storage space utilization.[2]

Review the procedures and methods for moving material from one storage location to another or from the storage area to the delivery area.

a. Determine whether material is being moved unnecessarily within the storage area.
b. Review the materials handling equipment.
   (1) Determine whether the equipment has been standardized to the extent practicable in order to simplify maintenance, repair, storage, and issue procedures.
   (2) Determine whether the possibility of standardizing the equipment was considered at the time of purchase, i.e., selection of equipment which could be used for multiple operations.
c. Review the procedures for the assignment of materials handling equipment.
   (1) Determine whether an equipment pool has been established and whether personnel operating from the pool are permanently assigned to a given vehicle. If a pool has not been established evaluate the feasibility of establishing one.[3]

Determine the adequacy and evaluate the utilization of refrigerated, temperature controlled, and dehumidified storage areas. Evaluate the appropriate utilization of storage aids, such as, racks, pallets, etc.[4]

Evaluate the procedure for determining when the use of waterproof packing materials will be used. Determine the appropriateness of the sealing methods utilized.[5]

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[1] Internal Audit Program No. 12: Supply Management, Audit Step A-21, p. 7.

[2] Ibid., Audit Step F-1, p. 29.

[3] Ibid., Audit Step F-6, p. 32.

[4] Ibid., Audit Step F-1-d-(3) and (4), p. 30.

[5] Ibid., Audit Step G-7, p. 36.

Observe the off-loading operations at dockside to determine whether material is being unnecessarily moved prior to being forwarded to its ultimate destination.[1]

If shop store stock records have not been centralized, determine the feasibility of establishing a central records unit to perform all inventory control functions relating to shop store material.[2]

Review the procedures for storing household goods and visit the storage areas.

a. Determine whether a copy of the inventory and packing list prepared by the contractor or the activity performing the packing is securely attached to the goods.
b. Determine whether barrels, crates and boxes are stored in an upright position as indicated by arrows or other markings.
c. Ascertain whether the storage space is subject to a minimum of warehouse traffic and whether fragile material is placed in the rear or sides of the storage space rather than adjacent to the main aisles.
d. If the household goods are stored in a space which has heating units or a sprinkler system, determine whether an unheated and nonsprinkler storage space could have been assigned.
e. Determine whether the storekeeper checks each lot received against the incoming inventory list to be sure that the lot is complete and whether he determines that goods accepted for nontemporary storage are properly packed and crated.
f. Determine whether the goods are properly protected from direct sunlight, damage from rough handling or collision, pilferage, etc. Ascertain whether only authorized personnel are allowed to enter the household goods area.
g. Review the procedures followed to ensure that goods in nontemporary storage are fumigated at least every six months.
h. Determine whether each lot is tagged with the owner's name.[3]

These audit steps could have considerable significance with regards to efficient management. An audit disclosing weaknesses would be unquestionably of service to management. What then is the underlying reason for these deletions from the programs? Primarily it is the fact that under

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[1] Ibid., Audit Step G-16, p. 39.

[2] Ibid., Audit Step J-7, p. 50.

[3] Ibid., Audit Step K-2, p. 54.

the present organization of the Naval Establishment much duplication exists in administration. Continual inspection and review by the Inspector General of the Navy, the Inspector General of the Supply Corps, the management bureaus, and the internal auditors are too expensive in dollars and manpower. The internal audit programs were carefully analyzed and those items which are examined thoroughly in other inspections were deleted.

CHAPTER V

FUTURE TRENDS

Internal Audit and the Computer

The installation of computers will make the task of the internal auditor more difficult. He will be required to participate somewhat in the advance planning of computer installation and programming. This will enable him to understand and appraise the programs and the built-in controls.

The greatest difficulty will be in following the audit trail of a transaction. The desire for faster machine operation and greater machine output will encourage management to eliminate the printing of inter-mediate sub-totals and other supporting data.

Manipulation can be avoided by building into the programs a supervision factor over each phase of operation. No one person must have independent control over what goes into the machines or what comes out.

Paul E. Hamman, a partner in the public accounting firm of Touche, Niven, Bailey, and Smart, suggests that we make the computer help the auditor. He writes:

> Auditing involves analysis of data and checking for exceptions. The auditor, for example, can ask the computer to list past-due accounts and provide an aging analysis. Slow-moving inventory can be identified for further investigation. The possibilities are endless.[1]

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[1]Paul E. Hamman, "Systems Design and Internal Control Related to Automated Data Processing," The Federal Accountant, Vol. VIII, No. 3 (March, 1959), p. 33.

Random Sampling

> It has long been recognized that the size, complexity, and volume of data generated both in government operations and by government contractors precludes in most cases a 100 per cent inspection and audit of the records and supporting documents. . . .
>
> Auditors, who necessarily deal with quantitative data when they audit large volumes of transactions, are frequently faced with difficult decisions involving the selection of a sample and the determination of its size. Since they obviously must work largely with such quantitative data, it seems logical that they should draw on and adapt statistical concepts and techniques and use them as effective tools in auditing practice.[1]

It has been proposed that random sampling techniques would eliminate the personal bias or subjective consideration from the choice of samples in internal auditing. Mr. Edwards B. Murray, in the Eighth Annual Thurston Award Paper, "Auditing the General Accounting Activity," sums up the advantages of statistical sampling techniques as follows:

> The great advantage of the statistical approach is that it permits the auditor to evaluate the risks he is assuming and to measure objectively the effectiveness and quality of detailed accounting work. Without this approach, it is too easy to base our evaluation of accounting work upon impressions, personalities, prejudice based on prior reputation and other intangible factors. I imagine most of us have encountered instances in which a few errors and inaccuracies did not seem too important because the man in charge of the work seemed to be a pleasant and cooperative person. On the other hand, there may be a tendency to be hypercritical of even small transgressions on the part of an individual who is personally obnoxious.[2]

The substitution of the statistical sampling procedures for "judgment sampling" is gaining additional support because of the economies which can be achieved. Small and thus economical samples can give relatively the same or better results than 100% coverage. Large installations can be audited with

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[1] W. P. Farnsworth and L. N. Teitelbaum, "Can Auditors Use Statistical Sampling Methods," The Federal Accountant, Vol. VI, No. 4 (June, 1957), p. 18.

[2] Edwards B. Murray, "Auditing the General Accounting Activity," Operations Auditing (New York: The Institute of Internal Auditors, 1958), p. 67.

equal success as small installations and yet use very little more time or personnel.

Conservative internal auditors prefer the use of good business judgment. A random sample may miss the odd amount which stands out like a sore thumb on a list of items to check.

CHAPTER VI

SUMMARY AND CONCLUSIONS

Summary

Internal audit is a type of control which functions by measuring and evaluating the effectiveness of other types of control. Its need arose with top management's inability to personally supervise the complexities of modern business.

Internal audit is a newcomer to the business scene. It began as an audit of fiscal records and reports in the accounting and financial departments. It is extending to an appraisal and evaluation of other departments.

It is essentially an independent staff function. Its acceptance by operating departments is almost in direct proportion to the ability of the auditor to function as a friendly advisor as contrasted to a decision maker.

Navy internal audit has followed the business pattern. The first audit programs were built around the verification and analysis of fiscal records. Later programs contain many audit steps which are not strictly fiscal in nature. Some of the latter have been deleted to reduce administrative duplication. Some of them remain.

A revolution in auditing techniques will occur with widespread use of the computer. It will probably be evolutionary in character and may even increase audit effectiveness and capability because of its speed.

There have been a considerable number of experiments with the use of random sampling or scientific sampling techniques. These have not had wide acceptance.

Conclusions

In industry there is a conflict between two schools of thought on the proper scope of internal audit. On the one side are those who feel it should be restricted to fiscal records or at the very least to the verification of other records and compliance with policy.

By contrast the other school believes there is no limit to the independent appraisal activity of the auditor providing he reports his findings to management and management makes the decisions.

Navy internal audit, at present, is taking the middle road. Financial audit steps were programmed first. Later programs became operational audits. The deletion of many of the operational audit steps was a management decision to avoid duplication. In any future reorganization of the Navy Department, a consolidation of all inspection and audit coverage into one segment is indicated since there is no reason for internal audit to be restricted to the appraisal of only fiscal records. Such an audit cannot provide all the effective service management can use. There should be a constant endeavor to expand the audit coverage providing it is economically feasible and generates useful data. If presented to operating management as cooperative assistance, the result can be beneficial to all departments. The internal auditor can be an expert in the field of controls -- a generalist in the technical areas. He can be the "Eyes and Ears for Navy Management."

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